

RURAL POLICY NOTE

the HOUSING ASSISTANCE COUNCIL

The Housing Assistance Council (HAC) is a national nonprofit organization that supports affordable housing efforts in rural areas of the United States. HAC provides technical housing services, seed money loans from a revolving fund, housing program and policy assistance, and research and information services. *HAC is an equal opportunity lender.*



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WHAT IS THE QRM? AND WHAT DOES IT MEAN FOR RURAL MORTGAGE MARKETS?

On August 28, 2013, a group of six Federal agencies issued a proposed rule to implement certain requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The group included Federal Banking Agencies (namely the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation) joined by the U.S. Securities and Exchange Commission, the Federal Housing Finance Agency and the Department of Housing and Urban Development.

One of the most important aspects of this proposed rule is that it defines the parameters for a Qualified Residential Mortgage (QRM).

Background on the QRM

In the late 2000s, fear of a possible collapse of the U.S. economy led to the passage of the Dodd-Frank Act. The Act attempts to address some of the causes of the crisis by tightening regulation of the nation's financial system. The proposed rule implements section 941 of the Act regarding asset backed securities (ABS). These securities are created by buying and bundling loans to be packaged and resold to investors.

In the run-up to the financial crisis, issuers (called securitizers in the rule) could, and commonly did, sell entire bundled packages of loans. The issuer had no obligation to assure the quality of the loans backing the security, and they also carried no risk if one or more of the loans failed to repay. This system led to questionable lending practices and unsound loans having a high probability of default and financial losses for borrowers and investors. Section 941 of the Dodd-Frank Act implemented a "risk retention" requirement for issuers of ABS. In essence, the rule promotes the concept of

“skin in the game,” ensuring financial companies hold a portion of the credit risk.

Specifically, the Act requires ABS issuers to retain at least 5 percent of the credit risk in the security. This creates an incentive for the issuer to monitor and ensure the quality of the assets underlying the ABS transaction. The Act also provides for an exemption when the loans behind the security meet underwriting criteria intended to result in a low risk of credit default. For residential lending, the regulation defines a class of mortgage loans called Qualified Residential Mortgages (QRM). Securities consisting of QRM loans are exempt from the risk retention requirements.

The Dodd-Frank Act

The Dodd-Frank Act created two classes of mortgage loans to be further defined by regulation. One provision, “Subtitle B--Minimum Standards For Mortgages” requires lenders to make a “reasonable and good faith determination” that a borrower has the “ability to repay” (ATR) the loan. This created the term “qualified mortgage” (QM).¹

Subtitle D of the Act entitled, “Improvements to Asset-Backed Securitization Process,” requires issuers to retain not less than 5 percent of the credit risk of any asset-backed security (ABS), that they transfer, sell, or otherwise convey to a third party.

“Asset-backed securities (ABS) are created by buying and bundling loans – such as residential mortgage loans, commercial loans or student loans – and creating securities backed by those assets, which are then sold to investors. Often, a bundle of loans is divided into separate securities with different levels of risk and returns. Payments on the loans are distributed to the holders of the lower-risk, lower-interest securities first, and then to the holders of the higher-risk securities.” The Act prohibits the issuers from hedging or otherwise transferring any of the credit risk to another party.

Certain types of transactions were exempted from the risk retention requirement. Securities comprised entirely of qualified residential mortgages (QRMs) do not have to hold some of the risk. The Act provides that the parameters for a QRM may not be broader than that of a qualified mortgage (QM). The Act instructs the Agencies “to consider underwriting and product features that historical loan performance data indicate result in a lower risk of default.”

The QRM; QM'S First Cousin

Two new acronyms have been added to the alphabet soup lexicon of housing policy and programs. While the Qualified Mortgage (QM) and the Qualified Residential Mortgage (QRM) sound similar, they relate to two distinct components of the Dodd Frank Act.

The **QM** generally refers to consumer specific components of Dodd Frank, particularly with “ability to repay” requirements.

The **QRM** relates to larger finance markets, especially the secondary mortgage market and the “risk retention” component of the law.

First Attempt: The Original QRM Proposal

In April, 2011, the Agencies published a proposed rule to implement these requirements. At that time, the Agencies noted the importance of securitization markets to the availability and cost of credit in the U.S. They also noted that Congress intended the risk retention requirements to serve as an incentive to issuers to monitor and ensure the quality of loans behind the securities.

¹ The Consumer Financial Protection Bureau (CFPB) defined the term under a separate regulation.

The original proposal, published before the CFPB's QM rule, prohibited QRMs from having certain product features. QRMs could not have negative amortization, interest-only payments, or significant interest rate increases. The proposal provided that QRM standards "reflect very high quality underwriting standards." The agencies anticipated that "a large market for non-QRM loans would continue to exist, providing ample liquidity to mortgage lenders."

Significant concerns were raised in public comments on the initial proposed QRM standard. A large down payment requirement was especially controversial. Such a requirement would significantly increase the costs of credit for most homebuyers and restrict access to credit. The repayment ratios were also considered overly restrictive. Other concerns included the possibility that the proposed QRM standard would become a new "government-approved" standard. This could result in a reluctance to originate mortgages that did not meet the standard. As a result, the Agencies conducted further analysis leading to modification of some parts of the original proposal.

QRM Redefined

After the QRM rule comment period, the CFPB implemented the QM standards. The new proposed rule defines QRM to have the same general criteria as a QM. Under the CFPB rules, a QM must have:

- Regular periodic payments that are substantially equal;
- No negative amortization, interest only, or balloon features;
- A maximum loan term of 30 years;
- Total points and fees that do not exceed 3 percent of the total loan amount, (slightly higher for loans of \$100,000 or less);
- Payments underwritten using the maximum interest rate that may apply during the first five years after the due date for the first regular periodic payment;
- Consideration and verification of the consumer's income and assets, including employment status if relied upon, and current debt obligations, mortgage-related obligations, alimony and child support; and
- Total debt-to-income ratio that does not exceed 43 percent.

CFPB's rule provided a temporary QM status for loans eligible for purchase, guarantee or insurance by one of the Government Sponsored Enterprises (hereafter Enterprise), HUD, the Veterans Administration, U.S. Department of Agriculture, or Rural Housing Service. These loans must also include:

- Regular periodic payments that are substantially equal;
- No negative amortization, interest only, or balloon features;
- A maximum loan term of 30 years;
- Total points and fees that do not exceed 3 percent of the total loan amount, or the applicable amounts specified for small loans up to \$100,000.

The temporary QM status expires (as applicable) once the Enterprise exits conservatorship or the relevant federal agency issues its own QM rules. A third category of QM was defined for certain small creditors. These are creditors with up to \$2 billion in total assets, originated no more than 500 first-lien mortgage loans in the prior calendar year, and hold the loan in portfolio for at least three years.

A mortgage meeting any of the QM definitions can qualify as a QRM. To be exempt from risk retention requirements, each loan must also be currently performing (i.e., the borrower is not 30 days or more past due) when the security is sold.

Alternative QRM Definition

The Agencies have discussed an alternative approach which was considered but not adopted. This approach begins with the QM criteria and adds standards selected to reduce the risk of default. The Agencies recognize that this would result in significantly fewer loans being exempt from risk retention but requested comments on this alternative.

Under this approach, a QRM must meet the CFPB QM underwriting requirements and the two exceptions outlined above are excluded. This approach, referred to as “QM-plus,” adds four additional factors as follows:

1. The loan must be a first lien mortgage, secured by the borrower’s principal dwelling.
2. The borrower could not be 30 or more days past due on any debt obligation nor 60 or more days past due on any debt obligations within the preceding 24 months.
3. The borrower must not:
 - a. have been a debtor in a bankruptcy proceeding in the last 36 months,
 - b. been subject to a judgment for collection of an unpaid debt;
 - c. had personal property repossessed;
 - d. had any one-to-four family property foreclosed upon; or have been engaged in a short sale or deed in lieu of foreclosure.
4. The Loan to Value ratio could not exceed 70 percent, including junior liens. Junior liens permitted only for non-purchase QRMs, property value determined by lower of appraised value or contract price (for purchases).

Where Do We Go From Here? Next Steps in the QRM Process

The rule was published for comment in the *Federal Register* on September 20, 2013. This proposed rule updates an earlier publication dated April 29, 2011. Comments are due on the current QRM proposed rule by October 30, 2013. The Housing Assistance Council will make public its comment letter on the proposed QRM rule in mid-October.

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FOR MORE INFORMATION ON THE ISSUE OF QUALIFIED RESIDENTIAL MORTGAGES

Proposed Credit Risk Retention (QRM) Rule:

<http://www.gpo.gov/fdsys/pkg/FR-2013-09-20/pdf/2013-21677.pdf>

HAC's Previous Comments on CFPB Ability To Repay (QM) Rule:

<http://www.ruralhome.org/information-and-publications/announcements/617-cfpb-comments-tla-amendment>

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